

East India Corporation Ltd., Madurai Vs. Commissioner of Income-tax, Madras

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Court : Chennai

Decided On : Jul-19-1965

Reported in : AIR1967Mad7; [1966]61ITR16(Mad)

Judge : Veeraswami and ;Venkatadri, JJ.

Acts : Income-tax Act 1922 - Sections 23-A

Appeal No. : T.C. No. 155 of 1962 (Ref. No. 80 of 1962)

Appellant : East India Corporation Ltd., Madurai

Respondent : Commissioner of Income-tax, Madras

Judgement :

(1) This reference relates to the propriety of an order under S. 23-A of the Income-tax Act 1922 and a direction given by the Tribunal under S. 34(3) of the same Act to re-assess the shareholders as a consequence of S. 23-A proceedings.

(2) The assessee was originally a private limited company incorporated in July 1942, but converted into a public limited company on 25-8-1948. For the assessment year 1954-55, for which the previous year ended on 31-12-1953, the Income-tax Officer found that it was not a company in which the public were substantially interested. On that view, he directed a sum of Rs. 2,43,588 being the undistributed portion of the assessable income of the company during the previous year as computed for income-tax purposes and reduced by the amount of income-tax and super-tax payable by the assessee in respect thereof should be deemed to have been distributed as dividends among the share-holders of the assessee as on 30-6-1954, the date of the general meeting at which the accounts for the previous year were laid. He formed this view on two grounds: (1) Equity shares of the assessee carrying not less than 25 per cent of the voting power were not beneficially held by the public at the end of the relevant previous year; and(2) The shares of the assessee company were not subject of dealings, in any stock exchange and the shares were not in fact freely transferable by the holders to other members of the public.

(3) On appeal by the assessee, the Appellate Assistant Commissioner of Income-tax did not accept these grounds, and reversed his order. He thought that as one of the share-holders of the company, the Saroja Mills, is a company in which the public were substantially interested, it should be held that more than 25 per cent of the voting power was held by that company. He further held that clause 13 of the Articles of the assessee which vested in the Directors discretion in the matter of transfer of shares and was but a common feature found in the Articles of what are undoubtedly public

limited companies in which the public are substantially interested, did not justify the Income-tax officer's finding that transfer of shares was here severely restricted, and, therefore, the shares of the assessee company were to in fact freely transferable. The Appellate Assistant Commissioner opined that the general restriction found in clause 13.

"was only in the nature of as 'de jure' restriction and cannot disentitle the assessee to urge its claim that the shares were in fact freely transferable"

The Department took the matter in appeal before the Income-tax Appellate Tribunal, Madras, it upheld the Appellate Assistant Commissioner's view on the first ground of the Income-tax officer, but differed from him on his second ground, and held that as clause 13 of the assessee's Articles did contain restrictions on the free transfer of shares it could not be said that the assessee had established that any transfer of shares was allowed up to the end of the relevant previous year. On appeal, before the Tribunal it would appear, in the first instance to have called for a report from the Income-tax Officer of particulars regarding the date of transfer, transferors and transferees of shares in the assessee company put the end of the accounting period relevant to assessment year 1954-55. The report submitted by the Income-tax Officer showed that on 22-7-1942, there was a transfer from Sri Karumuthu Thiagaraja Chettiar of 20 shares to Sri T. Manickavasagam Chettiar one of his sons, and on 2-8-1948, another transfer by the former of five shares to Thiagarajan Chettiar and Sons(P) Ltd., Coimbatore, and that no application for transfer was rejected by the assessee company. Thiagarajan Chettiar and Sons(P) Ltd., Coimbatore was stated to be a limited company whose shares were held exclusively by the members of Sri Thiagarajan Chettiar's family. During the arguments before the Tribunal, it seems an attempt was made on behalf of three assessee on the basis of a statement filed that subsequent to 2-8-1948, there had been further transfers on 10-11-1955, 3-5-1956, 18-3-1957, in February 1958 and June 1959. The Tribunal expressed the view that it had only to look at the position as it stood up to the end of the relevant previous year and that what happened afterwards was not germane to a consideration of the issue before it. Referring to clause 13 it said that where restrictions were placed on transfer, as in the instant case, the company could be held to be one in which the public were substantially interested, provided, the factual position upto the end of the relevant previous year showed that notwithstanding the restriction on free transfer of shares, transfer of shares was allowed freely among the members of the public. But, as we said, in view of clause 13 and of the particulars submitted by the Income-tax Officer, the Tribunal considered that the assessee failed to show that it was a company in which the public were substantially interested. Apparently, anticipating that the Tribunal might allow the appeal, the departmental representatives asked the Tribunal for directions under S. 34(3), as otherwise assessments of some of the shareholders of the assessee company under S. 23-A would hugely time barred. The Tribunal was minded to give these directions stating that in view of its decision, it gave the necessary direction.

(4) In the above circumstances, the following questions have been referred to us by the Tribunal under S. 66(1):

"1. Whether on a proper construction of the Articles of Association of the company, the shares are in fact freely transferable by the holders to other members of the public so as not to become liable to an order under S. 23-AP

2. Whether the direction under S. 34(3) to re-assess the share-holders as a consequence S. 23-A proceedings was legally given as a result of the Tribunal's finding?"

Before us, Mr. R. Venkataraman for the assessee contends that the Tribunal took a wrong view of the scope of the explanation to the third proviso to S. 23-A when it stated that transfers of shares of the assessee company made subsequent to the relevant previous year would not be germane to a consideration of the character of the company for purposes of S. 23-A. He argues that the words used by the Explanation are "or are in fact freely transferable by the holders to other members of the public", and having regard to the tense and the fact that in the amendment of the corresponding provision in 1955 the past tense has been used, the Tribunal while considering whether the shares of the assessee company were in fact freely transferable, should have taken into account the transfer of shares effected subsequent to the previous year. If that had been done, according to the assessee, it would be established that it is a company in which public are substantially interested. It seems to us that the argument does not precisely appreciate the scope and effect of the third proviso to S. 23-A and of the Explanation thereto. The question is not, as far as we can see, whether the transfer subsequent to the previous year can be taken into account. On that matter, we have no doubt that though the word "are" is used the tense is related to the end of the previous year. That this is so is obvious from a reading of the entire section with the third proviso and the explanation thereto. We are, however, of the view that notwithstanding the use of this phraseology and the tense, both before and after the amendment, in testing whether a company is one in which the public are substantially interested, transfers of shares even subsequent to the relevant previous year could be taken into account, like transfer of shares during and prior to that period. It must be borne in mind that the object is not to seek out transfers made before or after the previous year, but see whether the shares of the company are in fact freely transferable by the holders to other members of the public.

(5) "Transferable" ex facie is not to be equated to "transferred". The word imports a quality, legal effect arising out of or inherent in the character and nature of the shares themselves. This quality does not stand by itself, for, the section says "are in fact freely transferable". We have to give effect to each of these words, and if we did so, transferability is qualified by the fact which in the context, to our minds means a factual tendency which is unrestrained and which ensures transferability. In other words, we understand by the words "are in fact freely transferable" not that there should necessarily be actual transfers of shares, but a factual tendency towards free transfer of shares, subject, of course, to reasonable restrictions, by holders to other members of the public. If, for instance, the holders of shares are members of a family and the circumstances show that the company is intended to be a closed combine, this may justify an inference, in the light of those and other facts, that there is hardly any tendency either reflected from the treatment of the shares or from the composition of the shareholders towards the shares being in fact freely transferable. If there are transfers of shares to members of the public, that may be evidence on the factual transferability of shares without any unreasonable restraint or restriction. We think that this interpretation of the scope of the Explanation which learned counsel for the Revenue rightly urged before us, will be consistent with and fully give effect to the object of S. 23-A, namely, to avoid concentration of profits in the hands of companies under the guise or garb of a public limited company in which the public are supposed to be substantially interested. We are, therefore, of the view that the Tribunal will have to assess the relative facts over again to see whether the assessee

is company in which the public are substantially interested, more especially when we have not accepted the Tribunal's view that only transfers prior to the end of the relevant previous year could be taken into account. We do not have before us the necessary facts and circumstances in the light of which we can ourselves express an opinion as to whether the transfers of shares between November 1955 and June 1959 are to members of the public.

(6) Mr. Venkataraman for the assessee contends that cl. 13 of the Articles of the assessee is to by itself conclusive as to the character of the assessee company for the purpose of S. 23-A and that in fact, a clause like that is usually found in the Articles of many public companies which cannot be doubted to be companies in which the public are substantially interested, as for instance, the Indian Bank Ltd. Clause 13 of the Articles reads:

"The directors may at any time in their absolute and uncontrolled discretion and without specifying any ground decline to register any proposed transfer of shares. This clause shall also apply to a case where the proposed transferee is already a member."

The view according to the Income Tax Officer, as well as the Tribunal, in this clause is that it gives uncontrolled and unrestricted discretion, to the directors to refuse transfer of shares in a given case so that the directors can act arbitrarily and capriciously, and see that the shares are confined to particular members, excluding thereby members of the public. The argument of Mr. Venkataraman is that a power such as conferred by clause 13 on the directors is a fiduciary power which has to be exercised by the directors according to law and reason and not whimsically or arbitrarily., Counsel relies on *Muthappa Chettiar v. Salem Rajendra Mills Ltd.* Salem to

support his proposition. He also invites our attention to a circular of the Central Board of Revenue dated 1-7-1959. From that circular it appears that the Bombay Bench of the Appellate Tribunal had decided in one case that as long as there was a right to refuse transfer without assigning any reason it must hold that the shares were not freely transferable by the holder to the other members of the public. The Board of Revenue in effect directed the officers of the Income-tax department not to follow this rule, but suggested that the question whether shares were freely transferable or not was to be decided in the light of circumstances of each case. Learned counsel for the assessee contends that this is a Circular which the department officials were bound to follow under S. 5(8) of the Income-tax Act 1922, as held in *Navnitlal C. Javeri v. K.N. Sen*, . As to the last

argument, it is not necessary to say anything more than that so far as the tribunal and the courts are concerned, they are quite obviously not bound by such administrative directions. We do not think it necessary, however, to decide in this case, whether officials subordinate to the Board of Revenue are bound to follow them when they functions in a quasi-judicial capacity. In our view, the other question whether a company is one in which the public are substantially interested cannot be decided solely on the basis of a clause like 13 in the Articles. It is true, clause 13 vests in the directors absolute power to accept or not to accept applications for transfer of shares. Nevertheless, it is not to be suspected or assumed to begin with that the discretion vested in the Board of Directors will be misused so as to achieve an ulterior purpose. Facts any, however, appear on which it will be possible to find no

misuse of power in that way,. But, the point is that from the mere fact of absolute discretion being vested in the Board of directors it cannot be concluded that the shares in fact are not freely transferable. A contrary view would appear to have been taken by the Calcutta High Court in Commissioner of Income-tax West Bengal v. Tona Jute Co, Ltd. 1963-48 ITR 902 (Cal). With respect, we are of the view that, without further facts and circumstances which will warrant a conclusion that shares are in effect not transferable, it will be neither wise nor right to lay down as a general proposition that wherever a clause like 13 here occurs in the Articles, the shares must be taken to be not freely transferable.

(7) That takes us to the second question relating to the validity of the direction given by the Tribunal under S. 34(3). The tribunal's direction is this:--

"At the time of hearing of the appeal, the departmental representative drew out attention to the fact that the assessments of some of the shareholders of the assessee company are about to get time barred and that in the event of the appeal being allowed, suitable direction under S. 34(3) should be given by us in order that the assessments may be taken up and duly completed. In view of our above decision, we give the necessary direction."

Learned counsel for the assessee contends that this direction is wholly without jurisdiction. We have no hesitation in accepting this contention, though of course, on the view we have taken on the other question, the second question in a sense may not arise for an answer. Even so, we may express our view that the function of the second proviso to Section 34(3) is but to lift the time limit in certain cases, but not to widen the jurisdiction of the Tribunal. The Tribunal's jurisdiction is to be found in S. 33, and sub-section (4) of that section confines it to passing such orders as it may think fit on the appeal. That means, the Tribunal cannot travel outside the scope of the appeal and purport to give directions beyond its limits. The finding or directions referred to in the second proviso to Section 34(3) has reference only to the subject-matter of the appeal memorandum before the Tribunal. This view is supported by Income-tax Officer v. Murlidhar Bhagwandas, . The Tribunal here was not

concerned in the appeal with the consequence of an order made under S. 23-A, but only with the propriety of that order itself.

(8) We accordingly answer both the questions in favour of the assessee and against the department with costs. Counsel's fee Rs. 250.

(9) Answer accordingly.